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# Takaful (Shari'a Compliant) Insurance Companies

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This report highlights the main issues arising when applying A.M. Best's rating methodology to takaful insurance companies. Takaful insurance (or insurance compliant with Islamic beliefs) is clearly on the rise, particularly in the Middle East and Malaysia, and despite their many similarities with conventional mutual operating structures, A.M. Best believes there are distinctive issues with these companies that need to be highlighted. However, it is important to mention that the main principles on which A.M. Best's financial strength methodology are based remain unchanged, regardless of the type of company being analysed.

As is discussed later, each takaful company must establish a Shari'a board that sets the basic rules and principles governing the takaful company's activities, and ensuring that it operates within Islamic Shari'a principles. A.M. Best will not specifically comment on takaful companies' degree of compliance with Shari'a. However, as part of the interactive rating evaluation, A.M. Best will discuss items such as: the organization's corporate and management structure; the type of takaful business model employed; corporate governance and the role of the Shari'a board; and the insurer's performance versus key strategic and financial objectives. For further information on the breadth and depth of the rating evaluation, please refer to Appendix 1 – Sample Takaful Meeting Agenda.

The discussion that follows includes: a review of some of the key principles of takaful; how these principles are incorporated into a takaful company's business model; and how A.M. Best's rating methodologies are applied in the assessment of these organizations.

## Principles of Takaful

The first takaful insurer was established in Sudan in 1979, and the market now has grown to comprise more than 100 companies, including "windows" (operations affiliated with conventional insurers). Takaful includes both general (non-life) and family (life) products. The family product line includes life and health insurance plans, as well as education, accident and travel medical plans. The surge of takaful companies in recent times is a response to the commonly accepted incompatibility between Islamic beliefs and the conventional insurance model.

Takaful insurance is essentially a cooperative risk-sharing program established for the well-being of the community. The purpose of this system is not to generate profit, but to uphold the Islamic principle of Al-Takaful – "bear ye one another's burden." As a result, takaful insurance is based on the concept of mutual cooperation, solidarity and brotherhood. Takaful participants contribute (donate) to help protect one another against the impact of unpredicted risk and catastrophe, whereas in the conventional insurance model, policyholders pay premiums to protect themselves, or their interests, from some form of risk.

Other Islamic beliefs or principles that takaful operations intend to address are the avoidance of both uncertainty, particularly in terms of

the amount and timing of claim payments to be made; and excessive profit (seen as usury), be it in the form of payments received in the event of death, or any form of financial interest (i.e. bond coupon payments).

Underwriting and actuarial techniques apply in a similar manner as under conventional insurance, in that the takaful insurer evaluates the risk of potential loss and establishes a contribution (premium) base appropriate for that aggregate risk to protect the pool from undue losses. However, unlike the risk-based premium paid by a policyholder in a conventional insurance model (where each insured pays a rate commensurate with the assumed level of risk), each takaful participant shares equally in supporting the pool in recognition of the underlying principle of mutual cooperation.

As to reinsurance, it also should be based on the takaful pooling concept. The reinsurer should act primarily as a risk manager (retakaful operator) and should not profit excessively from the underwriting results. However, because of the relative lack of capacity and quality of true retakaful carriers, reinsurance with conventional reinsurers may be permitted under certain specified conditions and limitations.

## Takaful Models & Structures

For takaful programmes to be financially sound over the long term, as well as to provide incentive to takaful insurers to develop and promulgate these programmes to provide Muslims with alternatives to conventional insurance, these operators to some degree

## Retakaful Capacity and Financial Security Issues

Reinsurance following the same applicable Islamic principles as takaful insurance is known as retakaful. Reinsurance of takaful business through retakaful companies has been somewhat controversial within the Islamic insurance marketplace, as the growth of direct takaful writers has far outpaced the available capacity of retakaful. In addition, from a financial strength perspective, there have been ongoing concerns over the placement of reinsurance with lower or non-rated retakaful companies, as opposed to higher rated conventional reinsurers. As a result, takaful insurers in effect face issues with both retakaful capacity and financial security.

This has caused takaful companies to develop alternate strategies, including reinsuring on a conventional basis, contrary to the preference of seeking retakaful support. In recognition of this market reality, the Shari'a scholars have allowed takaful companies to seek support from conventional reinsurers under confined conditions. However, the preference still is to utilize retakaful companies whenever possible. Another manner in which takaful insurers have addressed the issue of retakaful capacity is to co-insure (a form of reinsurance) each other's direct takaful writings to reduce the heavy reliance on conventional reinsurance support.

The shortage of retakaful capacity may inhibit the growth of the takaful industry; however, A.M. Best has observed that the issue of retakaful capacity has begun to ease recently as an increasing number of new retakaful companies are being established in response to the market demands. As part of the rating evaluation, as with any insurer, A.M. Best will review the takaful insurer's reinsurance program and the quality and diversity of its reinsurance providers, including the exposure to counterparty credit risk.

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must be rewarded through profits in a more traditional sense. However, profits are not the end goal of the operation.

Muslims believe there is unity in diversity, so there is not one preferred operating model for takaful insurers. Shari'a scholars generally agree on certain fundamental components that are required to be an accepted takaful company; however, operational differences are tolerated as long as there is no contradiction to any essential religious tenets. There are now three primary operating models.

**Ta'awuni Model**

The Ta'awuni model (cooperative insurance) practices the concept of pure Mudharabah in daily transactions, where it encourages the Islamic values of brotherhood, unity, solidarity and mutual cooperation. In the pure Mudharabah concept, the takaful company and the participant share the direct investment income, while the participant is entitled to 100% of the surplus, with no deduction made prior to the distribution.

From the Ta'awuni concept, there are two basic models, Al Mudharabah and Al Wakalah. In reality, there are many variations of these basic models, but these variations fundamentally follow one of these two conceptual frameworks.

*Al Mudharabah.* This is a modified profit- and loss-sharing model. The participant and the takaful insurer share the surplus. The sharing of such profit (surplus) differs based on a ratio mutually agreed to between the contracting parties. Generally, these risk-sharing arrangements allow the takaful insurer to share in the underwriting results from operations, as well as the favourable performance returns on invested premiums.

*Al Wakalah.* This is a fee-based model. Cooperative risk-sharing occurs among participants where a takaful insurer simply earns a fee for services (as a Wakeel, or "Agent") and does not participate or share in any underwriting results. The insurer's fee may include a fund management fee and a performance incentive fee.

**Waqf Model**

Unlike the Al Mudharabah and Al Wakalah models, Waqf operates as a social/governmental enterprise, and programmes are operated on a nonprofit basis. Under the Waqf model, the surplus or profit is not owned directly by either the insurer or the participants, and there is no mechanism to distribute the surplus funds. In effect, the insurer retains the surplus funds to support the participant community.

This model, with a single surplus fund, is most like a conventional mutual insurance model. As such, it is rated in a very similar manner to conventional mutuals. For further information on the rating dynamics of mutual insurance companies, please see A.M. Best's "Rating European Mutual Insurance Companies."

The remainder of the report will highlight the unique elements of takaful companies following the Ta'awuni model, and how these factors are incorporated in the rating analysis.

## Main Characteristics of Takaful Companies

Takaful insurers have certain unique characteristics that recognize the key principles of Al-Takaful and fundamental Islamic beliefs.

*The establishment of two separate funds:* A takaful (or policyholders') fund and an operator's (or shareholders') fund. The takaful fund operates under pure cooperative principles, in a very similar way to conventional mutual insurance entities. Underwriting deficits and surpluses are accrued over time within this fund, to which the operator has no direct recourse. As a result, the takaful fund effectively is ring-fenced and protected from default of the operator's fund. Management expenses and seed capital are borne by the operator's fund, where the main income takes the form of either a predefined management fee (to cover costs) or a share of investment returns and underwriting results (or a combination of both).

*Solidarity principle and equal surplus distribution:* Given the fact that the takaful fund is seen as a pool of risks managed under solidarity principles, it is not meant to accumulate surpluses at levels excessively higher than those strictly needed to protect the fund from volatile results and to support further growth. Likewise, any fees or profit shares received by the operator should be just sufficient to cover management and capital costs while keeping the company running as an ongoing concern.

In case of financial distress for the takaful fund, the operator is committed to provide it with an interest-free loan, Qard' Hasan, for however long it is deemed necessary – providing an additional layer of financial security to the participants.

The surplus distribution structure is expected to be managed carefully and in a balanced way, so that neither policyholders nor operator make excessive profits at the expense of the other party.

*Restricted investments:* Shari'a compliance refers not only to the operational structure of the company, but also to its investment policy. Takaful companies must avoid investing in traditional fixed-income securities (due to the coupon interest payment attached). Instead, they are allowed to invest in sukuk (or Islamic bonds, where coupon payments take the form of a profit share on a particular enterprise). Moreover, investments in stocks (in principle allowed) should avoid the financing of non-Islamic activities (such as alcohol or gambling).

In practice, these restrictions often translate into an excessive concentration in stocks (due to the relative scarcity of sukuk), lower than average credit ratings (increased counterparty exposure) and high geographical concentration.

*Establishment of a Shari'a board:* An essential component in a takaful company's corporate governance is the establishment of a Shari'a board, in addition to the conventional board of directors. The Shari'a board is made up of recognised Islamic scholars, who ensure the company's operational model, profit distribution policies, product design and investment guidelines comply with Islamic principles.

Exhibit 1
**Basic Takaful Model**

The global shortage of recognised Islamic scholars in the insurance arena and lack of consensus in terms of what constitutes Shari'a compliance is, in A.M. Best's view, a challenge for more rapid development of the industry. Having said this, the emergence of some inter-regional and government-supported initiatives in this respect, as well as the participation of individual scholars in more than one Shari'a board, are positive signs of a gradual but slow trend toward convergence.

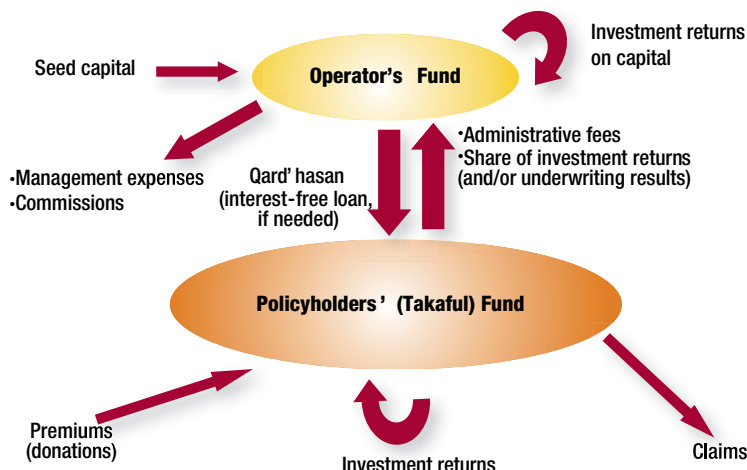
## Analysing a Takaful Company

As with conventional mutual insurance companies, takaful insurers have certain limiting features inherent to their business model, such as a relative lack of financial flexibility compared with stock companies, or increased concentration risk compared with broadly diversified insurers. However, both conventional mutuals and takaful companies typically experience a number offsetting factors that are viewed positively in the rating process, including high levels of retained surplus and increased persistency ratios and customer loyalty. This section discusses some unique elements of takaful insurers and how these are assessed in the rating process.

### Two Separate Funds – a Two-Stage Risk-Based Capital Approach

Given that one of the key characteristics of a takaful operation is the existence of two separate funds (the takaful fund and the operator's fund), the starting point for assessing the financial strength of a particular insurance company is to apply Best's Capital Adequacy Ratio (BCAR) proprietary model to the takaful fund in a way very similar to a mutual company.

This first-tier analysis compares the takaful fund's surplus to the capital required to support the fund's obligations to participants, per the BCAR model. The BCAR ratio for the takaful fund, as well as an analysis of the trends in the ratio and other key metrics, is the primary driver of A.M. Best's assessment of the takaful company's balance sheet strength.

A second-tier capital assessment also is performed on the operator's fund. The second-tier

analysis compares the surplus position of the operator's fund to the capital required to support the fund's obligations, per the BCAR model.

An operator's fund with much higher financial strength than its corresponding takaful fund normally will enhance the capitalisation assessment in respect of the whole insurance operation, reflecting the increased financial strength provided to the takaful fund's participants. This enhanced financial strength stems from the operator's obligation to provide an interest-free loan (Qard' Hasan) to the takaful or policyholders' fund in situations of financial distress. In cases where such a loan has been made to the takaful fund, the loan will be considered part of the takaful fund's capital base.

This consolidated view of capital, in effect combining the takaful and operator's fund for analytical purposes, is particularly important in the assessment of takaful insurers in the early years of operation. Currently, it is not uncommon for the operator's fund to be in a stronger relative position, given the relatively short track record of most companies with the resulting low level of surpluses accumulated at a takaful fund level.

An operator's fund with a weaker financial strength position will not detract from the overall analysis significantly, since the operator's fund cannot access the takaful fund surplus. However, in all cases, regardless of which fund is in a stronger relative position, it also is important to note that this two-tier analysis is supplemented further by a comparison of the capital accumulation trends in each of the separate funds to ensure an appropriate balance in the surplus distribution and fee structure.

**Main Drivers of Balance Sheet Strength in a Takaful Company**

Given the comparatively restricted investment policy of a typical takaful company; its consequent higher levels of counterparty risk; geographical concentration; and higher than average proportion of stock holdings, capital requirements in many cases are significantly larger than for a conventional company of a similar size.

The limited classes of invested assets long have been a barrier to the growth of the takaful industry, as well as a limitation on the development of more long-term products, due to the difficulty in addressing asset-liability management issues. The current situation has improved as the capital markets in Islamic countries have begun to mature and more Shari'a-compliant investment products are available in the market. However, demand is still higher than supply, resulting in increased expense for such investment products.

Exhibit 2
**Analysing a Takaful Company**

**Risk-adjusted capitalisation**
- Restricted investment policy
  - Higher counterparty risk
  - Geographical concentration
  - Higher stockholding concentration
  - ALM limitations
- Financial flexibility restricted to accrued surpluses
- Lack of retakaful capacity

BCAR applied to policyholders' fund (1st Tier analysis)

BCAR applied to shareholders' fund (2nd Tier analysis)

**Market environment and regulatory environment**
- So far restricted to personal and SME lines
- Uncertainty as to competitive advantages compared with conventional insurance
- Country risk may have negative impact due to early stages of development of market and regulatory environment
- Safeguards such as policyholders' funds ring-fencing and interest-free loan from operator yet to be tested

**Operating performance**
- Potential for adverse selection due to crude pricing
- Need for operators to recoup expenses
- Typically higher expense ratios (lack of economies of scale?)
- Lower investment yields due to restricted investment policy

Financial Strength Rating (FSR)

In terms of insurance risk borne by takaful companies, the currently moderate exposures and relative specialisation on domestic and small to medium-sized corporate lines should be expected to keep the capital requirements (as per the BCAR model) modest. These factors, nonetheless, easily can be more than offset by rapid growth of business and excessive concentration in a few product lines, with resulting pressures on capital needs.

An essential feature of all takaful models is participants' sharing of the underwriting surpluses/deficits. Accurately determining the surplus/deficit is, therefore, fundamental to the accounting process. Setting aside a reserve for contingencies always raises the question as to who of the policyholders own it, i.e. the participants that helped set it up or later generations. This is relevant because the significance of the reserve in the initial years of takaful operations is likely to be substantially greater than in subsequent years. This effectively will result in earlier participants paying to stabilize underwriting results for later participants.

Despite the possible inequity in a pure sense, the building up of a contingency reserve is desirable to enable stability in underwriting results and make it practical to expand the size of the risk pool (as there will be limits to what amounts the takaful operator will be able to provide as Qard' Hasan in case of deficits). A.M. Best considers contingency reserves as part of the capital and surplus of a company when assessing balance sheet strength.

As with conventional insurance operations, an important driving factor in the rating decision for a takaful company is its degree of financial flexibility (i.e. the company's ability to raise equity capital). As with mutual companies, the capital available normally would be expected to reflect significant surpluses accrued over the years within the takaful fund. This component of the analysis is focused mainly on the operator because of the mutual nature of the takaful fund and its inherent lack of financial flexibility. The assessment normally involves a detailed analysis of the ownership structure (and shareholders' solvency) and the record of share debt issues.

A.M. Best monitors carefully the quality of the reinsurance programme to assess a takaful company's balance sheet protection through reinsurance. This is particularly relevant given the previously mentioned lack of retakaful capacity (and virtual nonexistence of retro-takaful), which may force direct insurers to compromise the security of their acceptants.

**Operating Performance Issues in a Takaful Company**

In principle, any fees paid to the operator on average should be lower than the difference between premiums and claims. In other words, as long as the takaful fund continues to generate surpluses in the long term, there should be no major reason for concern. Having satisfied this condition, at a second level of analysis, A.M. Best believes that to ensure the ongoing existence of the whole insurance operation, it is important as well that the operator at least can cover its expenses from the fees received from the policyholders' fund.

During the past few years, takaful companies (particularly in the Middle East) have shown higher expense ratios than their conventional counterparts. The main driver, however, seems to be more a lack of economies of scale and comparatively lower use of technology, rather than solidarity principles. A.M. Best would expect the current gap to narrow in coming years as takaful business volumes continue to expand rapidly. In addition, A.M. Best expects that over time, the issue of higher expense ratios will be somewhat mitigated by higher customer loyalty and policy persistency driven by the participants' belief in the principles of takaful.

As for investment returns, given takaful companies' constraints in asset management, higher concentration in shares and in a particular geographical region, and increased counterparty credit risk, A.M. Best expects, takaful funds on average to yield lower risk-adjusted returns, experiencing higher volatility and credit defaults. Despite the continuous growth in the supply of Islamic securities, A.M. Best believes the investment opportunities are bound to remain limited for years to come.

**Market Environment and Country Risk**
Despite the continued impressive growth of the takaful sector overall, rapid growth has not been experienced in all product lines, as the expansion of general or non-life business has outpaced that of the family or life product line. In addition, the typical size of a takaful company remains smaller than that of a conventional insurer. Takaful insurers tend to be smaller, in part due to their relative lack of operating experience (takaful insurers have only been in existence since 1979), and the more limited operating profile of takaful insurers when compared with conventional insurers that have diverse operating platforms and more than a century of operating history.

Going forward, A.M. Best believes the main opportunities and challenges for the sector overall are the development of more robust life insurance platforms, and compulsory lines such as motor third-party liability and health within the non-life business (in particular countries). A growth area within the corporate product line is medium-sized business risk products within the energy and construction sectors, which continue to expand. In general, retention levels for corporate product lines have been improving gradually, providing a more stable base for growth, although the largest risks still are expected to be ceded to the international markets.

A.M. Best believes it is not yet clear whether takaful companies offer any competitive advantage within this market environment. It is debatable whether there is actually an untapped demand (especially in family/life insurance business) due strictly to religious beliefs – and whether this can be unlocked easily through the offer of takaful products.

A material component of the rating process focuses on the market position of the company – its diversification in terms of client base, business lines and distribution network. In particular for takaful companies based in the Middle East, all these factors are related closely to A.M. Best's country risk assessment. The early stage of development of complementary sectors or activities (e.g. Islamic bonds, bancassurance or Internet distribution and retakaful capacity) often may have a negative impact on the final rating assigned.

**Regulatory Environment**
**And Risk Management**
Moreover, in A.M. Best's opinion, some of the regulatory safeguards (e.g., ring-fencing of assets within the takaful fund, interest-free loans from operators in case of solvency difficulties, etc.) are yet to be tested. The development of the Islamic insurance industry, including the regulatory environment, needs to keep pace with the rest of the financial industry in the region (especially banking).

In A.M. Best's view, a robust regulatory regime is crucial for the development of a risk management culture. A.M. Best believes that given their constraints, takaful companies need to develop and demonstrate that they can apply an adequate risk-based approach to investment management (because of the reduced investment opportunities); capital adequacy and reserving (given the need for building up surpluses in the long term, especially for family/life business); and pricing/adverse selection control (given the restrictions on charging extra risk premiums for policyholders representing a greater risk of loss than the aggregate participant pool).

Overall, one of the unique challenges facing takaful companies – and A.M. Best as it endeavours to assess their financial strength – is the need to ensure that the objectives set by their Shari'a boards are consistent with key performance indicators based on conventional sound financial and risk management. That includes establishing processes to address all material risks, despite the challenges presented by the limited capacity of retakaful, and concentration risks presented by restrictive investment guidelines and the limited geographic diversity of the current takaful marketplace.

***Guides to Best's Financial Strength and Debt Ratings are available at www.ambest.com/ratings/methodology.***

Appendix 1

# Sample Takaful Meeting Agenda

**Organization Structure and Overview**
- Ownership and Participant Requirements
- Overview of Corporate Structure
  - Takaful Model Employed
  - Relationship between Takaful Fund and Operator's Fund (Sharing of Profits)
- Management Structure and Board of Directors
  - Senior Management
  - Board of Directors (if applicable)
  - Shari'a Board
- Assessment of Business Environment
- Key Strategic Objectives and Financial Targets
  - Takaful Fund
  - Operator's Fund

**Corporate Governance**
- Mission Statement
- Management's Perspectives on Key Risks
- Risk Management Framework
  - Roles and Responsibilities
  - Corporate Oversight
  - Shari'a Compliance
- Board Involvement
- Systems and Internal Controls

**Capital Structure**
- Composition
  - Takaful Fund
  - Operator's Fund
- Capital Management Strategy
- Capital Adequacy
  - Takaful Fund
  - Operator's Fund
  - Qard' Hasan
- Sources and Uses of Capital
- Cash and Liquidity

**Product Development and Underwriting**
- Product Offerings
  - General (Non-life)
  - Family (Life and Health)
- Geographic Footprint
- Retention
- Cycle Management Strategy
- Price Monitoring and Controls
- Expansion Initiatives and New Products
- External Risk Factors

**Marketing and Business Production**
- Competitive Market Position
  - Within Takaful Market
  - Within Broader Insurance Market
- Distribution Sources
- Distribution Productivity
- Production by Line of Business
- Business Strategies
  - By Line of Business
  - Short Term
  - Long Term
- Growth Targets by Line of Business

**Claims and Loss Reserves**
- Severity and Frequency Trends (General)
- Mortality and Morbidity Trends (Family)
- Claims Administration
- New Potential Claim Emergence
- Loss Reserves
- Management's Perspective on Reserve Adequacy

**Reinsurance**
- Reinsurance Program Overview
- Reinsurance Providers
  - Retakaful Providers
  - Commercial Providers
- Catastrophic Reinsurance Programs
- Credit Risk Analysis
- Net Retention

**Investments**
- Balance Sheet Composition
- Investment Strategy and Guidelines
- Performance of Portfolio
  - Gross and Risk-Adjusted Yields
  - Performance versus Benchmarks
- Asset-Liability Management
- Credit Risk
- Concentration Risk
  - By Asset Type and Geographic
  - Availability of Shari'a Compliant Assets
- Capital Markets Risk

**Financial Performance**
- Profitability by Line of Business
  - Sources of Profits
  - Profit Sharing between Takaful and Operator's Fund
  - Projections
- Operating Expenses – Operator's Fund
  - Trends
  - Expense Management Initiatives
  - Reported Expenses vs. Reimbursement from Takaful Fund
  - Budgets

Catastrophe Management Framework
- Natural and Man-Made Catastrophe Exposure

**Analysis**
- Catastrophe Models Used
- Probable Maximum Loss and Tail Risk Analysis
- Risk Aggregation and Mapping

**Enterprise Risk Management (ERM)***
- ERM Framework
- Risk Correlation
- Modeling Capabilities
- Risk Tolerance and Risk Management Objectives

**Other**
- Regulatory
- Legislative
- Judicial

* A.M. Best's expectation of a company's ERM capabilities will vary depending on an insurer's scope of operations, size and risk complexity. In some cases, a separate ERM meeting may be required.

Appendix 2
# Comparison of Basic Terms

| | Takaful and Conventional Insurance |
|---|---|
| **Accounts** | Takaful participant contributions are credited into one of two accounts, depending upon the type of takaful firm and any predetermined risk-sharing or profit-sharing arrangements. The two accounts are described below.<br><br>PA account (managed according to the al-Tabarru principle) – Funds whichthat are ring-fenced to cover policyholders' claims only (i.e. operators or shareholders do not have access to this fund).<br><br>PSA account (managed according to the al-Mudharabah principle) – Funds in which profit-sharing surpluses (between policyholders and shareholders, normally in fixed proportions) are accumulated.<br><br>In a conventional insurance model, the paid premium for both general and life products is credited into what is commonly referred to as the general insurance account. For certain life products in which the policyholder maintains ownership and control of the assets, payments often are referred to as deposits and are placed in a segregated or separate account. |
| **Bonus** | Takaful contracts specify from the outset how the profits from takaful investments are to be shared between the operator and the participants. This is done in accordance with the principle of al-Mudharabah, and the share split typically is expressed in the form of a ratio as agreed between the participant and the operator – regardless of the amount of investment profit made during the year.<br><br>Certain types of conventional insurance may offer some form of bonus or profits in general terms related to either investment or underwriting performance. This bonus may take the form of a dividend payment, an increase in insurance coverage or lower premium payments. The conventional carrier can decide to give or not to give a bonus for any particular year, depending on the result of the investment and/or underwriting returns. The rate of bonus itself can vary from year to year and typically is at the discretion of the company's board of directors. |
| **Claims** | In a takaful policy, if the participant dies, or the covered risk occurs, the beneficiary(s) may claim the policy value from the PSA, in addition to the accumulated account value from the PA. In the case where the participant survives at the maturity of the policy, or if the covered risk does not occur, his/her claim is confined to the account value available in the PA.<br><br>In conventional insurance, when the policyholder dies or the covered risk occurs, the beneficiary(s) may claim the whole amount named in the policy (often referred to as the face amount of a life policy), or the prescribed reimbursement for loss as defined in a general insurance policy. When a covered risk does not occur, the insured is not entitled to any reimbursement of premium or investment results in many forms of conventional insurance, such as term life insurance and typical personal general insurance. However, for certain types of investment-related products, the insured shall have the right to claim the policy value at maturity together with the interest, if any. |
| **Damages** | In takaful, in compliance with the Islamic principles of mutual cooperation and shared responsibility, there is no justification to award unlimited or unreasonable damages related to any claim or dispute.<br><br>Under the conventional insurance model, the local court system with jurisdiction in a particular matter (depending on the relevant statutes and laws in the jurisdiction) often is empowered to award unlimited punitive damages against the insurer. |
| **Extra Risk Premiums** | In takaful, generally, the contribution or premium rates imposed are fixed by the actuarial evaluation for the entire risk pool. No participant is charged a higher rate, or is discriminated against due to foreseeable extra risk. However, if a particular participant is considered to have an extraordinary risk profile and poses an undue strain on the mutual fund, the participant may have to increase his proportion of Tabarru, i.e. the contribution from his premium to the PSA. In other words, the participant's total contribution remains the same, but the portion that is credited to his/her PA would be less than it generally would have been.<br><br>In conventional insurance, an extra premium typically is charged in addition to the normal amount against the policyholder where an extra risk is foreseeable. For example, in life insurance, an extra premium may be charged to reflect the higher mortality rates for smokers or people with highly dangerous and strenuous jobs, such as firefighters, miners and so on. Similarly, in non-life insurance, an extra premium may be charged to reflect higher probable losses for a home located in a flood zone. |
| **Guarantees** | In takaful, the operator gives no contractual guarantees. The underlying principles of community, solidarity and brotherhood create joint indemnity or risk sharing among the participants.<br><br>In the conventional model, the insurer guarantees the payment of the benefit or claim within the stipulations of the contract. |
| **Investments** | In takaful, the funds must be invested in non-interest bearing assets where investment returns are generated through some form of profit sharing or appreciation. All investments must comply with the guidelines of Shari'a. As such, investment returns must not be driven by any unethical commercial activities that may be in conflict with Islamic beliefs.<br><br>Under the conventional model, assets typically are invested in a variety of interest-bearing assets, such as fixed-income instruments, as well as in equity-related securities. Each company typically develops a set of investment guidelines considering domestic insurance regulation, the profile of the insurer's liability base and the company's appetite for risk. |

Appendix 2

## Comparison of Basic Terms *(continued)*

| | Takaful and Conventional Insurance |
|---|---|
| **Premium** | In takaful, fixed minimum contribution or premium rates are set and are the same for all participants, in deference to Islamic principles and beliefs.<br><br>Under the conventional model, premiums paid by the policyholder vary based on the risk profile of the individual or corporate entity. For life policies, attained age when the policyholder first takes out a policy is one of the key elements of the pricing decision. The older the policyholder is at the time of contract, the higher the level of premium, reflecting the increased mortality rate as age increases. Similarly, for non-life auto policies, the safety features and relative repair cost of a vehicle are taken into account when determining premium rates. |
| **Profits** | In takaful, the proportion or split of any profits typically is prescribed in the contract; however, the amount of profits in total depends on the aggregate investment and underwriting performance for the period.<br><br>In a conventional insurance policy, there generally is no provision for profit sharing, other than through the dividend or bonus schemes mentioned above. |
| **Term of the Policy** | All takaful policies have a fixed and definite term or period of maturity, e.g. 10, 15, 20 years, etc. This is in recognition of the Islamic principle of avoiding uncertainty (Garar).<br><br>In conventional insurance, the term of a policy varies based on the type of policy. Some life insurance policies have a definite time period, such as temporary and endowment assurance policies, while others may have an indefinite period as long as the policyholder continues to make premium payments. As for general insurance, there typically is a term specified in the contract. |

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